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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 319

EM. H. METTLER & SONS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 61–77) are not reported. The *per curiam* opinion of the Court of Appeals (R. 478) is reported at 181 F. 2d 848.

JURISDICTION

The judgment of the Court of Appeals was entered on May 12, 1950. (R. 479.) A petition for rehearing, filed by the taxpayer on June 10, 1950, was denied on June 22, 1950. (R. 480.) The petition for a writ of certiorari was filed on September 20, 1950. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether the Tax Court's decision was clearly erroneous in sustaining the Commissioner's determination that the taxpayer's expenditure for compensation for its five principal officers and stockholders was in excess of reasonable compensation and that, to that extent, the taxpayer was not entitled to a deduction under Section 23 (a) (1) (A) of the Internal Revenue Code?

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and Regulations involved are set forth in the Appendix, *infra,* pp. 17–19.

STATEMENT

The taxpayer, incorporated under the laws of California on December 22, 1941, is engaged in the business of developing, producing, harvesting, packing, shipping, and marketing potatoes for seed and commercial use. It kept its books and filed its income and excess profits tax returns on the accrual and calendar year bases. (R. 61–62.)

Taxpayer acquired, as of January 1, 1942, all of the business and assets, having a stated valuation of $326,400, theretofore owned by Em. H. Mettler and his wife, Pauline Mettler, in exchange for the issuance to them on May 23, 1942 of a certificate for 3,264 shares of its stock. (R. 62, 64–65.) On June 25, 1942, pursuant to sales by Em. H. Mettler and Pauline Mettler, the original certificate was cancelled and stock was issued as

follows: 500 shares to Stephen J. Fairchild and Helen M. Fairchild, 500 shares to Orvin Mettler and Merle F. Mettler, 500 shares to Dan E. Weitz and Gertrude P. Weitz, and 120 shares to Raymond A. Mettler and Thea C. Mettler. Orvin and Raymond Mettler are sons of Em. H. Mettler. Fairchild and Weitz are sons-in-law of Em. H. Mettler. (R. 65.)

Em. H. Mettler, Orvin Mettler, Raymond Mettler, Fairchild, and Weitz constituted taxpayer's board of directors in 1942. (R. 65.) At the first meeting of the board of directors, on January 6, 1942, Em. H. Mettler was elected president, Orvin Mettler, vice-president, and Stephen J. Fairchild, secretary-treasurer. On February 3, 1942, the directors elected Dan E. Weitz assistant secretary, authorized each director to draw on the taxpayer's bank account and outlined the duties of each as follows (R. 63–64):

> Em. H. Mettler shall have general supervision of crop production. Orvin Mettler shall have supervision of the packing, shipping, sales including seed sales, and immediate supervision of the production at Shafter. Dan E. Weitz shall have supervision of the equipment of the corporation and the immediate supervision of production at Lerdo. Raymond A. Mettler shall have immediate charge of the production at Edison. Stephen J. Fairchild shall have charge of production at Santa Maria.

On March 3, 1942, at a regular meeting of the board of directors, held at Shafter, California, the following proceedings were had (R. 64):

> The matter of salaries for the managers of various enterprises of the corporation was brought up. After discussion, it was decided that salaries should be paid along similar lines to those paid by the business prior to incorporation.
>
> Upon motion duly made, seconded, and carried the following resolution was adopted:
>
> Resolved: That salaries for the year 1942 for employees of the corporation listed below shall be to each one-sixth of the net income of the corporation computed without deducting the salaries fixed herein. That regardless of the above, the salary for 1942 for each employee listed herein shall not be less than $12,000.00 nor more than $35,000.00. The employees referred to herein are: Em. H. Mettler, Orvin Mettler, Stephen J. Fairchild, Raymond A. Mettler and Dan E. Weitz.

The testimony indicates that the directors agreed on this maximum salary because the Bureau of Internal Revenue had not disallowed somewhat similar deductions in 1936 when the business was operated as an individual proprietorship. (R. 186, 217–218, 270.) Mettler, prior to the incorporation of the business, had paid the following amounts to his sons and sons-in-law for the years indicated (R. 66):

Year	Orvin Mettler	Fairchild	Weitz	Raymond Mettler
1934	$6,440.40	$6,440.40		
1935	5,380.89	5,380.89	$4,842.80	
1936	36,211.37	36,211.37	32,950.24	
1937	26,257.98	26,257.97	25,054.46	
1938	11,839.50	11,839.50	11,839.50	
1939	4,743.61	4,743.61	4,743.61	
1940	17,116.08	17,116.08	17,116.08	$10,269.64
1941	2,511.36	2,511.36	2,511.36	1,906.81

Mettler's gross income from farming, amounts paid as salaries to these employees, and net farming income during the years 1936–1941 had been (R. 66):

Year	Gross Income	Salaries	Net Income
1936	$420,198.35	$105,412.98	$86,150.49
1937	372,917.21	79,570.40	72,182.28
1938	240,946.78	35,518.50	33,914.88
1939	139,983.61	14,230.83	9,509.32
1940	242,294.77	61,617.88	28,726.88
1941	178,892.71	9,440.89	[1] 2,805.30

[1] Loss.

In his income tax return for 1936, Em. H. Mettler claimed a deduction of $105,412.98 for salaries paid to Orvin Mettler, Fairchild, and Weitz. The Bureau of Internal Revenue notified Mettler of an adjustment based upon an interest credit, but did not disallow any part of the deduction for salaries for 1936. (R. 65.)

Taxpayer's gross farming income in 1942 was $606,026.88 and its net income before deducting the salaries here involved was $219,541.33. (R. 66.) No dividends were paid by the taxpayer

in 1942. (R. 65.) During 1942, taxpayer operated 14 ranches in Kern and Santa Barbara Counties in California, covering about 1,800 acres, of which taxpayer owned about 400 acres. All lands were cultivated and nearly all were irrigated. (R. 66.)

Em. H. Mettler was born November 15, 1887. He began farming in California in 1901, and began farming in Shafter in 1919, producing cotton, potatoes, grapes, tree fruit and alfalfa. He continued farming at Shafter from 1919 to 1932, and in that period acquired other farms. Mettler bought foundation potato seed and raised commercial seed potatoes which he sold. In 1937, his potatoes became diseased with ring-rot and the market was lost. Thereafter, he commenced to develop a foundation seed of his own, and established a laboratory to reduce diseases in his product. His organization devised or adopted and developed methods of combating potato diseases and of improving the quality of potatoes. He was considered by some as the best potato grower in California and the demand for Mettler's potatoes in 1940 and thereafter always exceeded the supply. His organization devised machinery and equipment for planting and for handling potatoes in bulk. (R. 66–67.)

Orvin Mettler was born May 29, 1907. He attended California Polytechnic College for one semester, and then entered his father's employ in

1932. He was associated with his father from 1932 through 1941. In 1942, he entered taxpayer's employ and had general supervision of the ranches at Shafter, as well as of the packing sheds, purchasing, grading, and marketing. (R. 67.)

Stephen J. Fairchild was born November 1, 1902. He attended Occidental College in Los Angeles County for one year, University of California Agricultural School at Davis for two years, and University of California at Berkeley for one year. He received the degree of Bachelor of Science. He married in 1927. He was employed in agricultural work of various kinds, including six years as foreman of a citrus association. On December 1, 1933, he entered the employ of Mettler under a written agreement by Mettler to give him one-sixth of the net profits of Mettler's farming activities for one year and was in Mettler's employ until 1942 when he entered the employ of taxpayer. He did research concerning potatoes while in college and thereafter. While in Mettler's employ he did bookkeeping and office work and participated in Mettler's development of a foundation seed potato. In 1942, he had charge of the packing shed at Santa Maria Ranch. (R. 67–68.)

Dan E. Weitz was born February 25, 1910. He attended Junior College at Bakersfield for one year. He entered Mettler's employ in 1934

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at an hourly wage. In 1935, Mettler agreed to pay him 15 percent of his net profits. In 1938, and until 1941, Mettler paid Weitz one-sixth of his net profits. In 1939, Weitz supervised the Lerdo district and the maintenance shop at Shafter for all Mettler's equipment. Weitz entered taxpayer's employ in 1942, having the same duties. (R. 68.)

Raymond Mettler was born August 29, 1918. He attended Santa Maria Junior College for one year and University of California College of Agriculture at Davis where he graduated in 1939. He then went to work for his father. In 1940 and 1941, Mettler paid Raymond 10 percent of his profits. Raymond had charge of preparing the Edison District land for production. In 1942, Raymond entered the employ of the taxpayer and had charge of the Edison ranch. (R. 68.)

The Commissioner increased taxpayer's 1942 net income and excess profits net income in the amount of $106,500 by disallowing that amount of the total salaries of $175,000 paid by taxpayer during 1942 to its five key employees who also were its chief officers and directors. The following explanation was given by the Commissioner in his deficiency letter (R. 63):

> (a) The deductions for salaries claimed on your income tax return for the calendar year 1942 are disallowed in the amounts stated below, since deductions claimed on your return are held to be unreasonable

under section 23 of the Internal Revenue Code:

Name	Compensation Claimed	Reasonable Compensation	Compensation Disallowed
Em. H. Mettler	$35,000.00	$20,000.00	$15,000.00
S. J. Fairchild	35,000.00	15,000.00	20,000.00
Orvin Mettler	35,000.00	13,500.00	21,500.00
Dan E. Weitz	35,000.00	12,000.00	23,000.00
Raymond Mettler	35,000.00	8,000.00	27,000.00
Total	175,000.00	68,500.00	106,500.00

On the taxpayer's petition to redetermine the Commissioner's deficiency determination, the Tax Court held that the taxpayer had not established that it was entitled to the full deduction or that the Commissioner's deficiency determination was erroneous. (R. 69–77.) The Court of Appeals affirmed *per curiam* (R. 478.)

ARGUMENT

1. The decision below is correct. The question whether the salaries paid by the taxpayer, a family corporation, to its five key employees (who were also the principal officers, directors, and stockholders) exceeded what would be reasonable compensation for the services which they actually rendered, involves an issue which is primarily factual in nature.[1] The Tax Court, after a care-

[1] *Hoffman Radio Corp.* v. *Commissioner*, 177 F. 2d 264 (C. A. 9th); *Locke Mach. Co.* v. *Commissioner*, 168 F. 2d 21 (C. A. 6th), certiorari denied, 335 U. S. 861; *L. & C. Mayers Co.* v. *Commissioner*, 131 F. 2d 309 (C. A. 2d), certiorari denied, 318 U. S. 773; *Clinton Co.* v. *Commissioner*, 159 F. 2d

ful consideration and analysis of all the pertinent matters in a rather voluminous record, concluded that the payment of $35,000 to each exceeded a reasonable allowance for compensation to the extent disallowed in the Commissioner's deficiency notice, and, accordingly, that the payments were not deductible in full as ordinary and necessary business expenses under Section 23 (a) (1) (A), Internal Revenue Code (Appendix, *infra,* p. 17). (R. 61–77.) The Court of Appeals, unpersuaded by the same matters which are still being urged by the taxpayer, and unconvinced that the Tax Court's decision was "clearly erroneous,"[2] affirmed *per curiam.* (R. 478.)

While a detailed discussion of all the underlying evidence and of all the permissive inferences that could be drawn is not now appropriate, reference to only some of the more significant matters is convincing that the Tax Court's resolution of this factual controversy is fully warranted by the record, that its decision is not clearly erroneous, and that the Court of Appeals correctly affirmed.

The payment of large salaries by a family corporation to its principal stockholders requires

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102 (C. A. 7th); *Miller Mfg. Co.* v. *Commissioner*, 149 F. 2d 421 (C. A. 4th); *Crescent Bed Co.* v. *Commissioner*, 133 F. 2d 424 (C. A. 5th).

[2] Section 1141 (a), Internal Revenue Code, as amended by the Act of June 25, 1948, c. 646, 62 Stat. 869; Rule 52 (a), Rules of Civil Procedure; *United States* v. *Yellow Cab Co.*, 338 U. S. 338, 340–342; *United States* v. *Gypsum Co.*, 333 U. S. 364, 394–395.

special scrutiny lest what is claimed as a deductible payment for services rendered may actually be a distribution of profits or other nondeductible outlay. *Crescent Bed Co.* v. *Commissioner,* 133 F. 2d 424 (C. A. 5th). This is particularly true where, as here, the compensation is fixed on a contingent basis. Such compensation, to be reasonable, must be the result of an arm's length bargain which is influenced only by the employer's desire to obtain the services "on fair and advantageous terms." Section 29.23 (a)–6 (2), Treasury Regulations 111 (Appendix, *infra,* pp. 18–19). That this was not the situation in the present case is evident from the fact that, as the Tax Court noted (R. 76–77), each of the stockholding members of the family group was awarded identical compensation notwithstanding the wide disparity in their experience, education, background, and in the duties and responsibilities which they performed for the taxpayer (R. 66–68). Indeed, those who testified on the matter all agreed that, in fixing the amount of the compensation, the board of directors (composed of the same persons who received the salaries) selected a figure which it was thought would be allowable as a tax deduction because a similar amount had not been disallowed in the past. (R. 186, 217–218, 270.) There was, apparently, no attempt to ascertain on what fair and advantageous terms the directors could have secured the

services in question. Further, the absence of any distribution of corporate profits by way of dividends (R. 65), or of any plan for such distribution is persuasive that such a salary arrangement was, in part, a method of siphoning off corporate profits in the guise of compensatory payments.

In this connection, it is relevant to observe, as did the Tax Court (R. 76), that the relatively high income enjoyed by the taxpayer in 1942 was not attributable alone to the services of these individuals but, instead, was largely accounted for by favorable crop conditions and by exceptional price factors arising from war demand and the Government's farm program. Under such circumstances, salaries which are geared to profits do not reflect reasonable compensation for services rendered.

While the record is replete with detailed descriptions of the nature of the taxpayer's business and the duties performed by these employees, there is completely lacking any cogent evidence demonstrating what "would ordinarily be paid for like services by like enterprises under like circumstances." Section 29.23 (a)–6 (3), Treasury Regulations 111 (Appendix, *infra,* p. 19). The absence of such evidence represents a serious defect in the taxpayer's case. *Gem Jewelry Co.* v. *Commissioner,* 165 F. 2d 991 (C. A. 5th), certiorari denied, 334 U. S. 846; *Clinton Co.* v. *Commissioner,* 159 F. 2d 102 (C. A. 7th); *In re Rae's Estate,* 147 F. 2d 204 (C. A. 3d).

The factual minutiae referred to by the taxpayer (Pet. 2–10, 17–20), scarcely need detailed comment, since there is nothing in the record which, by itself, would compel the Tax Court to arrive at an opposite factual conclusion or which, except as indicated below, the taxpayer even relies on as requiring such a result. The taxpayer does, however, contend that there was direct, competent evidence that the salaries paid were reasonable. (Pet. 7, 11, 13.) It attempts to support this assertion by referring (Pet. 7–8) to the opinion testimony of Henry M. Boyd (R. 408–423).[3] It is true that Boyd stated that in his opinion the compensation paid to each of these employees was reasonable. (R. 415–416.) However, the basis on which his opinion was formulated was such that it was entitled to little, if any weight. He was a wholesale distributor of

[3] The taxpayer also asserts that Em. H. Mettler and Stephen Fairchild, two of the employees whose salaries are involved in this case, testified (Pet. 8) "that this method and rate of compensation was reasonable." Reference to the portions of the record relied on by the taxpayer (R. 287–295, 344–345) reveals no direct testimony concerning the reasonableness of the salary payments during the taxable year. Consequently, the Tax Court did not have to decide what weight could have been given to the opinions of these interested witnesses if they had so testified. Their testimony which concerned the reasonableness of salary payments in prior years when the business was conducted by Em. H. Mettler, as an individual, and when salaries and business conditions were different, has no conclusive bearing on the ultimate issue arising under the taxable year in controversy.

potatoes and onions; consequently, he had no direct experience in the taxpayer's business of raising potatoes. He had never had any previous occasion to consider the reasonableness of the salary of an employee of such a corporation (R. 419). His opinion seems to have been based entirely on what he had been told other proprietors had earned (R. 420–421). Further, since these involved earnings of individuals or joint venturors, his reference to earnings failed to eliminate the element of fair return on investments, as distinguished from compensation solely for services, the only relevant consideration in the case of a paid employee. (R. 419–420.) Nor did he explain how employees with such varying experiences and duties could, nevertheless, each be entitled to identical amounts as reasonable compensation for their services. The Tax Court, carefully considering his testimony (R. 75–76), quite properly found his opinion to be (R. 76) "of little probative value."

The taxpayer introduced no compelling proof which would have required the Tax Court to conclude that the salary payments were deductible in full as reasonable compensation for services rendered. Furthermore, when the matters which point the other way are taken into consideration, it seems undeniable that the Tax Court was warranted in refusing to disturb the Commissioner's deficiency determination. Even if the evidence could be

viewed as justifying a contrary decision of the Tax Court, its choice "between two permissible views of the weight of evidence is not 'clearly erroneous'." *United States* v. *Yellow Cab Co.*, 338 U. S. 338, 342.

2. There are no conflicting decisions. *Mayson Mfg. Co.* v. *Commissioner,* 178 F. 2d 115 (C. A. 6th); *A. & A. Tool & Supply Co.* v. *Commissioner,* 182 F. 2d 300 (C. A. 10th); and *J. H. Robinson Truck Lines* v. *Commissioner,* 183 F. 2d 739 (C. A. 5th), relied on by the taxpayer (Pet. 11–16) as creating a conflict, all rest on their own facts. They do not apply principles regarding the "clearly erroneous" test which are opposed to those inherent in the decision below. In the *Robinson Truck Lines* case, *supra,* for example, there was testimony by two disinterested witnesses who were in a position to know that the contested salary payments were the same as those paid for similar services by comparable industries and that the payments were reasonable under the circumstances. The same kind of evidence was offered with respect to certain contested rental payments. No positive testimony or other circumstances contradicted or discredited this evidence. Similarly, in the *Mayson Mfg. Co.* and the *A. & A. Tool Supply Co.* cases, the uncontradicted opinion evidence that the disputed payments were reasonable was given by witnesses

who were in a position to have an informed opinion.

While the soundness of those decisions may be seriously questioned, they are not in conflict with the decision below. The cited cases do not hold that a Tax Court decision is "clearly erroneous" if it refuses to accept with finality the opinion of a witness concerning the reasonableness of an amount claimed as a tax deduction where, as here, the witness has himself demonstrated that he is ignorant of the crucial facts on which knowledge is necessary before a sound opinion can be formulated, and hence that he is not in a position to express an informed opinion. In addition, in the present case, other circumstances disclosed by the record strongly refuted the witness' opinion concerning the crucial fact in issue.

CONCLUSION

The decision below is correct. There is no conflict in decisions and no other reason appears warranting review by this Court. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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OCTOBER 1950.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 23 [as amended by Sec. 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—
>
> (1) *Trade or Business Expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.
>
> * * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

> SEC. 29.23 (a)-6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influ-

enced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

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